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The Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

economics.sen@aph.gov.au

Tax Laws Amendment (Research and Development) Bill 2013

Dear Sir/Madam,

We welcome the opportunity to comment on the impact of the Tax Laws Amendment (Research and Development) Bill 2013, which was referred to the Senate Economics Legislation Committee for inquiry on 5 December 2013.

Caltex is disappointed the Australian Government has decided to proceed with the former government's proposal to deny companies, such as ours, access to the research and development (R&D) tax incentive. This appears to be in direct contrast to the Coalition's *Policy to boost the competitiveness of Australian manufacturing*, in which it states that it "places a completely different emphasis on the importance of increased commercial R&D in Australia" and that "we need to be encouraging growth in R&D".

We do not support the bill and therefore agree with its referral to the Senate Economics Legislation Committee for inquiry. We request that the government reconsider the proposed changes as they are likely to undermine R&D investment and, subsequently, productivity growth in Australia.

Caltex's key concerns with the bill include:

- Turnover can be a poor measure of profitability, and this is the case for the downstream oil industry, given turnover is driven by crude oil and refined product prices, whilst fuel marketing margins tend to be independent of such external factors. As a result, the tax incentive changes will unfairly impact on a small number of companies, such as Caltex, which have high assessable incomes but relatively low profits.
- The policy change will add further costs to Australian manufacturers, such as oil refiners, who continue to face competitive and cost pressures. As a result, the changes will be detrimental to the competitiveness and productivity of the manufacturing industry in Australia.

In our submission, we identify options to avoid what we believe are unintended consequences for the downstream petroleum industry.

Caltex believes that a more suitable approach would be to use a two-step eligibility test, which utilises both turnover (revenue) and taxable income as metrics. Under our proposal, the first test should determine whether a company's revenue is $20 billion or over. If this initial test is satisfied, the second test then considers if the taxable income is $2 billion or more. If both tests are satisfied, then a company would be considered ineligible for the R&D tax concessions.

We have an alternative option that would address the downstream petroleum industry more directly, as discussed in the attachment.

We look forward to an opportunity to discuss these issues and proposals further with the Committee. If you require further information, please contact George Chenouda, Manager Tax,

Yours sincerely,

Simon Hepworth
Chief Financial Officer

Caltex submission to the Senate Economics Legislation Committee inquiry into the Tax Laws Amendment (Research and Development) Bill 2013

1. Caltex's business

Caltex is the leading transport fuel supplier in Australia, underpinned by a flexible and reliable supply chain. The integrated business incorporates supply, refining, logistics and marketing. Caltex's vision is to be the outright leader in transport fuels across Australia.

Caltex is the only oil refining, fuel and convenience marketing company listed on the Australian Securities Exchange, with more than 27,000 shareholders, including institutions, retail investors, employees, and Chevron Global Energy Inc. (which has a 50% shareholding). Caltex is an ASX100 company, under Australian management. A minority of directors are Chevron employees.

About 3,500 people are employed nationally across Caltex's supply chain including refining, terminals, distribution, commercial and industrial sales, and fuel and convenience retailing.

Caltex has operations in all states and territories, with a national network comprising of 89 depots and about 2,000 service stations, including company-owned and franchised sites, resellers, independent operators and Caltex Woolworths co-branded outlets. The company also sells directly to commercial and industrial customers of all sizes, including transportation, aviation and agricultural enterprises.

Caltex supplies over one third of wholesale transport fuels (petrol, diesel and jet fuel) nationally. Caltex has a branded retail petrol market share of about 18 per cent nationally (excluding Woolworths co-branded sites).

Caltex has and will continue to actively maintain its focus on cost control, cash flow and debt management. A key priority for Caltex is the strengthening of the base business. This will enable future growth in earnings through operational and capital efficiency and the optimisation of our integrated supply chain.

2. Caltex's participation in the R&D tax incentive

Caltex is of the view that the availability of the research and development (R&D) tax incentive has a direct positive impact on the level of investment which industry participants are willing to commit to R&D.

By their very nature, the vast majority of R&D projects undertaken by Caltex in the local oil refining industry are capital and labour intensive, requiring significant levels of funding and resourcing, including highly-skilled workers.

Caltex received a total of $4.2 million in R&D tax incentives from the federal government between 2009 and 2012, which contributed to R&D for operational improvements at our refineries, R&D in crop protection products, and software development.

Caltex's R&D drives technical innovation and the development of new knowledge in the industry. In order to remain competitive in the Australian market, it is essential that Caltex continues to invest in the development of new technologies and processes. Also, as an organisation, Caltex promotes a culture of operational excellence, regularly seeking business improvements in all aspects of its operations.

Caltex continues to commit significant levels of funding for R&D activities which are designed to bring about process improvements and product enhancement and minimise our impact on the environment.

We therefore believe it is imperative that corporations such as ours which contribute to the development of technical know-how and the skills of Australian workers on such a large scale continue to be eligible for the R&D tax incentive.

3. Caltex does not support the bill

Caltex understands the arguments put by the Government, the Opposition and The Greens, which were well articulated in the debate in the House of Representatives on 9 December 2013. All parties support greater industry innovation and productivity and see an important role for R&D in achieving this outcome. However, there are differences on the R&D policy settings.

As we understand it from Hansard, Labor opposes the Bill because the cut to R&D eligibility, while originally proposed by them, is not part of a broader jobs package as was proposed when Labor was in government, so the overall impact on industry and employment would be negative. The Greens oppose the Bill because they regard R&D in Australia as already inadequate and would like to see a substantial increase in both private and public R&D spending.

On the other hand, the Government sees the reduction of eligibility for the R&D incentive as necessary for budget savings in the interests of the economy as a whole, including those companies that are adversely affected by the R&D tax changes in the Bill.

We note the Coalition's policy for the 2013 election (*The Coalition's policy to boost the competitiveness of Australian manufacturing, 21 August 2013*) which says the "Rudd-Gillard Government similarly punitive move in 2013 to completely disqualify a range of companies from receiving any incentive to invest in Australian R&D was widely condemned" and effectively supports the view that these R&D eligibility changes are undesirable.

The Parliamentary Secretary to the Treasurer, Steven Ciobo MP, referred on 9 December 2013 in debate on the Bill to a statement by the then Shadow Treasurer on 16 May 2013 that "the Coalition ... reserves the option to implement all them [Labor's cuts] in government, as short-term emergency measures to deal with the budget crisis Labor has created". He also justified the changes on the grounds the R&D incentive would be better targeted as a result of the Bill.

Caltex does not wish to engage in a political debate over what was said by parties when the Bill was put forward by Labor then revived in slightly modified form by the Coalition. However, we oppose the Bill, not on political grounds, but because we believe it would have an adverse effect on businesses including Caltex, and the budget savings should be achieved through broader policy measures that should be determined in the 2014 budget process and the various reviews that are underway and proposed.

We note that the Coalition's manufacturing policy committed to a 2014 review of the R&D incentive program and broader consideration of R&D taxation incentives in the taxation white paper. On this basis, the Bill would seem premature and this is another ground for Caltex's opposition to the Bill.

We note other submissions to the Committee oppose the Bill on additional grounds, which seem to us to have merit. However, we defer to industry experts in this policy field to present those arguments to the Committee.

4. Restrictions on access to the R&D tax incentive are poorly targeted

The policy rationale behind the Tax Laws Amendment (Research and Development) Bill 2013 (the Bill) is to better target the R&D tax incentive by denying it to companies with very high assessable income. These companies are assumed to have high profits and in turn are readily able to fund R&D without a tax incentive.

<u>However, the policy will unfairly impact a small number of companies such as Caltex, which have high assessable incomes but relatively low profits</u>.

In the Attachment, Table 1 (based on data from BRW) shows that most companies with total revenue in excess of $20 billion also earned after-tax profits in the billions of dollars. However, in the past five years, Caltex's highest profit after tax (excluding significant items) was $435 million.

This data reveals a fundamental problem that profitability (hence the ability to afford R&D) and assessable income are not always well correlated. There is a particular anomaly in the case of downstream oil companies, including Caltex, because raw material costs (i.e. crude oil) and the cost of goods sold (i.e. primarily petrol, diesel and jet fuel) are very high relative to total revenue.

For the year ended 31 December 2012, Caltex's revenue (similar to assessable income) was $23.6 billion, and is likely to increase in the future. This revenue included cost recovery from customers of excise paid in excess of $5 billion. Even if the eligibility criterion was changed to exclude excise, we anticipate that assessable income less excise will exceed $20 billion within a relatively short period if sales continue to grow and oil prices remain high.

Revenue net of excise was therefore about $18.6 billion. For the year ended 31 December 2012, Caltex's cost of goods sold amounted to some $16.8 billion. Other costs then needed to be deducted in calculating net profit.

Once all revenues and costs were accounted for, Caltex's after tax profit in 2012 was $57 million (on a historic cost basis) or $458 million (on a replacement cost basis).

Under the Bill, taxpayers with aggregate assessable income in excess of $20 billion will not be eligible for the incentive. In Caltex's case, this figure will be exceeded so we will lose eligibility for the R&D tax incentive.

As a relatively small Australian company, with significant manufacturing interests (oil refining), the R&D tax incentive makes a small but important contribution to the ongoing viability of our operations. Removing the incentive for companies like Caltex runs counter to the Government's efforts to support Australian business and manufacturing.

5. Proposals for an amended eligibility test

As discussed above, profitability (i.e. the ability to afford R&D programs) and assessable income are not always well correlated. We believe this creates an anomaly in the Bill because the high cost of sales for petroleum companies results in high assessable income relative to profit.

5.1 Option 1 – addition of profit criterion

As an alternative, Caltex proposes that the assessable income test be supplemented by a test based on taxable income (which is a reasonable proxy for profit before tax). This would represent a two-step eligibility test for access to the R&D tax incentive.

The first test (as proposed) would determine whether or not an R&D entity has an assessable income of over $20 billion. This is exactly the same test as proposed in the Bill.

If this threshold is exceeded, the second test would determine whether an R&D entity has a taxable income of over $2 billion. If both thresholds are exceeded, then a company would be ineligible for the R&D tax incentive.

The proposed section 355-103 of the Bill could be amended to include the following:

> '(3) An R&D entity that is not entitled under subsection (1) for a tax offset for an income year will still be entitled to a tax offset under section 355-100 if its taxable income is $2 billion or less for an income year.'

5.2 Option 2 – additional provision for petroleum retailers

If Option 1 is for some reason not acceptable, an alternative way to overcome the anomaly created by the assessable income criterion is suggested by existing tax law: in relation to petroleum marketing, there is an existing provision in Income Tax Assessment Act (ITAA) sub-section 328-120(3) that excludes from the assessable income of petroleum retailers the sales revenue arising from petroleum products, as follows:

> (3) In working out an entity's annual turnover for an income year, do not include any amounts of ordinary income the entity derives from sales of retail fuel.

This sub-section was included in the ITAA because the high costs of goods sold in the petroleum retailing sector exaggerated the turnover for small businesses operating in the sector. As a result, these small businesses were unfairly excluded from the small business definition for the purposes of the Pay As You Go withholding tax which is obtainable by other small businesses.

If this provision were adapted to the definition of assessable income solely for the purpose of testing eligibility for the R&D incentive, it would effectively remove the impact of the high cost of goods from assessable income. As a result, Caltex's assessable income for the purpose of R&D eligibility would be greatly reduced and the anomaly would be removed.

The proposed section 355-103 of the Bill could be amended by adding the following sub-section, which draws directly on the wording of ITAA sub-section 328-120(3):

> '(3) In working out an R&D entity's assessable income for an income year, do not include any amounts of ordinary income the R&D entity derives from sales of direct and retail fuel and excise.'

Attachment

Table 1: Top 20 companies by revenue and net profit after tax (NPAT)

Rank	Company	Total revenue ($billion)	Net profit after tax ($billion)
1	BHP Billiton	72	15.2
2	Rio Tinto	60	5.7
3	Wesfarmers	58	2.1
4	Woolworths	56	1.8
5	National Australia Bank	49	4.1
6	Commonwealth Bank of Australia	47	7.1
7	Westpac Banking Corporation	42	6
8	ANZ Banking Corporation	40	5.7
9	Telstra	26	3.4
10	Xstrata Holdings	23	3.2
11	Caltex Australia	23	-0.7*
12	Shell Australia	22	-0.5
13	BP Australia	21	0.8
14	QBE Insurance Group	21	0.7
15	Suncorp Group	16	0.7
16	Qantas	16	-0.2
17	NSW Health	16	0.09
18	Fonterra Co-op Group	15	0.5
19	Origin Energy	13	1
20	Metcash	12	0.09
29	SingTel Optus	9	0.8
61	Xstrata Coal Investments Australia	5	0.7
62	Woodside Petroleum	5	1.5
65	CSL	5	1
71	Newcrest Mining	4	1.1
75	Chevron Australia	4	2.1
76	Westfield Group	4	1.5
95	Santos	3	0.8
132	Mitsui Iron Ore Development	3	1.6
134	Shell Energy Holdings Australia	3	0.8

*Source: BRW Top 1000 Companies in 2013; *Note: RCOP NPAT (pre-significant items) $0.3 billion.*
RCOP results remove the impact of fluctuations in the US$ price of crude and foreign exchange on cost of sales, which is separately identified as inventory gains/(losses) in the statutory accounts.